

**DEPARTMENT OF STATE REVENUE  
LETTER OF FINDINGS: 02-0205  
STATE INDIVIDUAL INCOME TAX  
For the Tax Years 1997, 1998, and 1999**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUES**

**I. Statute of Limitations on Issuance of Proposed Assessment – Individual Adjusted Gross Income Tax.**

**Authority:** IC 6-8.1-5-2(a); IC 6-8.1-5-2(b).

Taxpayers argue that the Department was without authority to issue a proposed assessment of additional individual adjusted gross income taxes for the year 1997.

**II. Assessment of Additional Individual Income Taxes on Taxpayers' Receipt of "S Corporation" Distributions.**

**Authority:** IC 6-8.1-5(b); I.R.C. § 1363(a).

Taxpayers maintain that the Department of Revenue (Department) erred in calculating their taxable income attributable to distributions of income received from their S Corporation.

**STATEMENT OF FACTS**

Taxpayers are the owners and officers of an Indiana S Corporation. In 2000, the state Board of Accounts conducted an audit of the taxpayers' S Corporation. Within the subsequently published report, the audit made note of certain disbursements to the taxpayers. As a result of that report, the Department conducted a desk examination of the taxpayers' Indiana individual income tax returns for 1997, 1998, and 1999. The Department concluded that taxpayers had failed to report certain income derived from the S Corporation. Consequently, the Department issued taxpayers notices of "Proposed Assessment." The taxpayers submitted a protest questioning the validity of the 1997 assessment and the accuracy of the 1997 through 1999 assessments. An administrative hearing was held, and this Letter of Findings followed.

## **DISCUSSION**

### **I. Statute of Limitations on Issuance of Proposed Assessment – Individual Adjusted Gross Income Tax.**

Taxpayers argue that the Department was without authority to assess additional taxes on the taxpayer's 1997 income. The Department's notice of Proposed Assessment, for the additional 1997 taxes, was issued on February 4, 2002.

The Department's authority to propose an assessment of additional taxes is constrained by IC 6-8.1-5-2, which reads as follows:

Except as otherwise provided in this section, the department may not issue a proposed assessment under section 1 of this chapter more than three (3) years after the latest of the date the return is filed, or any of the following:

(1) the due date of the return . . . (IC 6-8.1-5-2(a)).

The due date of the taxpayer's 1997 return was April 15, 1998. Therefore, under IC 6-8.1-5-2(a), the latest date on which the Department was authorized to issue the notice of proposed assessment was April 15, 2001.

However, under certain circumstances, the Department's authority to issue notices of Proposed Assessment extends past the three-year limitation. In relevant part, IC 6-8.1-5-2(b) states:

If a person files an adjusted gross income tax (IC 6-3) . . . return that understates the person's income, as that term is defined in the particular income tax law, by at least twenty-five percent (25%), the proposed assessment limitation is six (6) years instead of the three (3) years provided in subsection (a).

For the 1997 tax year, the Department notice of Proposed Assessment constituted an assertion that taxpayers had underpaid their 1997 taxes by approximately 33 percent. Having made that determination, the Department was authorized to issue the notice of Proposed Assessment for the 1997 tax year before April 15, 2004.

## **FINDING**

Taxpayer's protest is respectfully denied.

### **II. Assessment of Additional Individual Income Taxes on Taxpayers' Receipt of "S Corporation" Distributions.**

A desk examination of taxpayers' 1997, 1998, and 1999 individual income tax returns concluded that taxpayers had failed to report certain income derived from their wholly owned S

Corporation. Generally, an S Corporation pays no tax. I.R.C. § 1363(a). Instead, the S Corporation's income is passed through to the individual shareholders.

An examination of the taxpayers' Indiana IT-40 individual income tax returns, federal individual income tax returns, and federal S Corporation returns indicates that taxpayers reported and paid taxes on all income received from taxpayers' S Corporation. The desk audit erred when it concluded that the subsequent distributions from that income were subject to the individual income tax. Generally, distributions of S Corporations are not taxed because the amounts involved were taxed previously when the income was first earned.

Taxpayers have met their burden of proof, imposed under IC 6-8.1-5(b), of demonstrating that the proposed assessments are wrong.

### **FINDING**

Taxpayers' protest is sustained.

DK/JM/MR – 021107